October 22, 2012

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, DC 20219

Jennifer Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitutions Avenue, N.W.
Washington, D.C. 20551

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Via agency website

Re: Comment Letter on Proposed Rule "Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule" (OCC Docket Number OCC-2012-0010 (RIN 1557-AD46); Board Docket No. R-1442 (RIN 7100 AD-87); FDIC RIN 3064-AD97)

Ladies and Gentlemen:

The Coalition for Derivatives End-Users (the "Coalition") is pleased to respond to the request for comments by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively, the "Prudential Regulators") in connection with the proposed rule entitled "Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule" (the "Proposal").[1] Hundreds of companies have been active in the Coalition throughout the legislative and regulatory processes. The businesses and professionals we represent come from diverse sectors of the economy and serve as job creators and engines of economic growth in the United States and around the world. Our message is clear: Financial regulatory reform measures should promote economic stability and transparency without imposing undue burdens on derivatives end-users. Imposing unnecessary regulation on derivatives end-users, who did not contribute to the financial crisis, would create more economic instability, restrict job growth, decrease productive investment, and hamper U.S. competitiveness in the global economy.

[1] 77 Fed. Reg. 52977 (August 30, 2012).

End-user companies predominantly use derivatives to hedge or mitigate risk and not for speculative or investment purposes. This use of derivatives to hedge risk benefits the domestic and global economies by allowing a range of businesses—from manufacturing to health care to agriculture to technology—to improve their planning and forecasting and offer more stable prices to customers.

We support the broad policy objectives of the G20 regulatory reform agenda and we recognize the important role capital requirements play in protecting the financial system from risks associated with a wide range of banking activities, including those activities related to derivatives. At the same time, we have significant concerns about the Proposal's effect on end-users of derivatives. In particular, the Proposal is likely to discourage end-users from prudently managing their business risks and/or will drive up the costs of risk management. In particular, the Proposal will have a more pronounced effect on small and medium sized businesses.

In drafting Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),[2] Congress acknowledged the important role derivatives play in mitigating end-users' commercial risks and the corresponding benefit the economy derives from such activity. Indeed, Congress crafted an end-user exception from the clearing and trading requirements of Title VII.[3] Further, policy makers have repeatedly emphasized the importance of implementing a derivatives regulatory regime that promotes, rather than discourages, risk management activity by end-users.[4]

In its current form, the Proposal would significantly undermine Title VII's end-user exception by driving up the cost of hedging. The end-user exception was designed to maintain the efficient risk management markets for end-users and ultimately consumers. The end-user exception also reflected a conclusion that end-users do not meaningfully contribute to systemic risk. We urge you to amend the Proposal to ensure this objective is similarly reflected in the capital requirements framework. Specifically, we urge Prudential Regulators to alter the Proposal such that the new CVA capital requirements not apply to transactions executed with end-users when the end-users are hedging business risk.

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[2] Public Law 111–203, 124 Stat. 1376 (July 21, 2010).

[3] 7 U.S.C. 2(h)(7).

[4] For example, House Agriculture Committee Chairman Peterson stated that Congress had "given the regulators no authority to impose margin requirements on anyone who is not a swap dealer or a major swap participant." In response, House Financial Services Chairman Frank agreed, saying that "the gentleman is absolutely right. We do differentiate between end-users and others." 156 CONG. REC. H5248 (June 30, 2010) (colloquy of Representatives Frank and Peterson).

We further note that European policy makers are considering exempting corporate end-user risk mitigation activities from aspects of the capital requirements regime in Europe.[5] We believe it is essential that U.S. regulators coordinate internationally to ensure that U.S. companies are not disadvantaged as compared to European businesses.

1. CVA Charge and Its Impact on Derivatives Transaction Pricing

The Proposal implements a new Credit Valuation Adjustment ("CVA") risk capital charge intended to provision for the potential increase in CVA in a stressed market environment. Banks and end-users presently calculate CVA under U.S. GAAP based on current credit conditions. The new CVA charge is prospective and contemplates a severe deterioration in credit conditions. The measures used to calibrate such deterioration dictate that banks set aside substantial sums against the potential losses such scenarios could create.

Available data[6] suggests that the increase in end-user derivatives transaction pricing will be significant, likely increasing derivatives capital requirements by a multiple of current levels. Because an end-users' bank swap dealer counterparties will be required to hold significant new capital against such end-users' hedging transactions, bank swap dealer counterparties will need to generate reasonable returns on the capital they are required to set aside. Consequently, bank swap dealer counterparties will increase the transaction prices offered to end-users, driving up the cost of hedging and increasing costs to consumers.

These transaction price increases will be especially large on long-dated swaps, where capital requirements are especially large. Those market participants that finance long-term assets such as real estate, power-generation facilities, and other infrastructure projects (e.g., airports, roads, bridges, etc.) often rely on long-dated hedges to control and mitigate exposure to rising interest rates and inflation, as well as currency risk, associated with long-term financing.

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5 In its CRD IV text, European Parliament included an amendment (in italics) to Article 372 of the CRR which reads: "Transactions with a central counterparty *and transactions with non-financial counterparties referred to in Art. XX of EMIR, provided that these transactions are objectively measurable as reducing risks directly related to the commercial or treasury financing activities of the non-financial counterparty,* are excluded from the own funds requirements for CVA risk." While trialogue negotiations are ongoing, the final text is moving toward acceptance that transactions with non-financial counterparties should be exempted from the own funds requirement for CVA risk, provided that transactions are being conducted for hedging purposes.

6 For example, an August 1, 2012 Risk Magazine article entitled "Risk 25: How Basel III is turning borders into barriers", explained that for derivatives transaction prices for A and A- rated corporates transacting on an uncollateralized basis with 7-year cross-currency swaps, transaction prices increased more than three-fold when comparing Basel II and Basel III. Whereas US banks will be transitioning from Basel I to Basel III and whereas Basel I is higher than Basel II, we note that the cost increase for US market participants will not be as high as the cost increase for non-US firms in relative terms. However, the absolute increase in price will be significant in any event.

Additionally, the increase in transaction pricing will disproportionately affect small and medium-sized businesses resulting from the capital requirements framework which allows for a reduction in the capital charge if the banking institution hedges credit risk with credit default swaps ("CDS"). While the largest corporations may have CDS associated with their debt obligations, small and medium sized enterprises typically do not. Consequently, swap dealers will be unable to hedge the credit risk associated with small and medium-sized entities' derivatives activities. Small and medium-sized businesses would thus be the most vulnerable to the substantial transaction price increases that result from the Proposal.

2. Other Impacts of the CVA Charge

End-users whose debt obligations can be hedged with CDS may find their overall cost of financing increase as a result of the Proposal. Such an increase emanates from the hedging activity undertaken by financial institutions in order to reduce capital requirements. Such dealer hedging activity will place upward pressure on CDS spreads, the result of a demand-driven increase in protection buyers. Thus, larger end-users will likely find that their debt pricing increases as a result of swap dealers' credit hedging activities.

3. Impact of Increased Derivatives Transaction Pricing on End-Users

The increase in transaction pricing is likely to have a detrimental impact on end-user hedging decisions. While such increased transaction prices theoretically create an incentive for end-users to clear their derivatives transactions or otherwise use standardized derivatives contracts, such options are of limited use to many end-users for multiple reasons.

- **Collateral**: Cleared/standardized derivatives place liquidity/collateral demands on end-users. Many end-users are unwilling to incur such liquidity and collateral demands. Such demands result from initial and variation margin requirements that apply to such transactions – requirements that cause end-users to sideline cash or reserve debt capacity to ensure they are able to fund margin requirements even in extreme market stress scenarios. Many end-users are simply not willing or able to tolerate uncertain/variable margin requirements and will avoid utilizing derivatives instruments that require margin. Thus, rather than having their intended effect of creating an incentive for clearing, capital requirements will instead simply increase the cost of hedging on an uncleared basis for many end users.
- **Standardization**: Standardized contracts (e.g., futures contracts) are often incompatible with adequately mitigating customized risks. When an end-user utilizes a standardized hedge, it often does so at the expense of basis risk, wherein the hedge and the hedged risk are mismatched. Changes in the value of the hedged risk are not perfectly offset by changes in the value of the hedge. For public companies concerned with hedge accounting, such basis risk may disrupt its ability to claim hedge accounting treatment, or may cause the company to recognize hedge ineffectiveness.

For these reasons, rather than responding to cost incentives to centrally clear their derivatives transactions or to use standardized products, many end-users will continue using uncleared OTC derivatives at significantly higher prices. Still others will opt not to hedge and will seek other ways to mitigate risk exposure. For example, some companies will increase consumer prices so as to create buffers against the volatility of cost inputs.

4. Reconciling the End-User Exception with the Proposal

The resulting outcomes of the approach proposed by the Prudential Regulations (i.e., sharp transaction price increases) for corporate end-users are not reasonable. Notably, the outcomes are disconnected from the historical loss experience related to end-user risk management activity. Indeed, historical losses on uncleared OTC derivatives by end-users have been quite small, even throughout the financial crisis. Since inception of the financial crisis, available data suggest worldwide financial institution losses and write-downs on all types of financial products totaled $2.08 trillion. Of this amount, less than 4% were the result of OTC derivatives.[7] The vast majority of the losses attributable to OTC derivatives derived from AIG and monoline insurance companies, whose derivatives use varies considerably in magnitude and purpose from the derivatives use of end-user hedgers.

Indeed, such data contributed to the determination by Congress to exempt non-financial end-users from the salient economic requirements of Title VII of the Dodd-Frank Act. Similarly, Prudential Regulators have acknowledged the low systemic risk contribution of end users on multiple occasions.[8] In addition to these loss data, the following information further supports the decision by Congress and the acknowledgements by regulators that accord special provisions for non-financial end-users.

- Non-financial entities represent a small fraction of the OTC derivatives market. Statistics released by the Bank for International Settlements ("BIS") indicate that non-financial entities comprise only 7.6% of the derivatives market.[9]
- Non-financial entities do not rely heavily on the kinds of derivatives that were closely associated with the financial crisis. Importantly, the products that these entities typically rely on do not exhibit the "jump-to-default" characteristic evident in the credit derivative

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[7] Bloomberg WDCI function as of 11/15/2011.

[8] Federal Reserve Board Chairman Ben Bernanke in a June 14, 2011 letter to Committee on Agriculture, Nutrition and Forestry Chairman Stabenow, wrote, "Nonfinancial end- users appear to pose minimal risks to the safety and soundness [of] covered swap entities and to U.S. financial stability." In a December 2010 letter to Senator Crapo, he wrote, "The Board does not believe that end-users other than major swap participants pose the systemic risk that the legislation is intended to address."

[9] Bank of International Settlements, OTC derivatives market activity in the first half of 2011, November 2011: www.bis.org/publ/otc_hy1111.pdf. The use of derivatives by non-financial entities is but a small fraction of the derivatives use of systemically significant users of derivatives. Large dealer banks are typically party to $50 trillion or more in derivatives contracts; AIG was party to $2 trillion at the time of its government bailout; Long Term Capital Management was party to $1.2 trillion at the time of its industry bailout; even the largest non-financial entity derivatives users are party to only a small fraction of these amounts.

transactions that were closely associated with the financial crisis. For example, less than 0.5% of derivatives products used by non-financial entities are credit default swaps.[10]

- Non-financial entities predominantly use derivatives to reduce risk and not to take on risk for speculative or investment reasons. Through hedging, an end-user's loss on a derivative is offset by a corresponding gain in their business.
- Non-financial entity risks are heterogeneous and dispersed across tens of thousands of companies. As such, one company's loss on derivatives does not portend significant losses for non-financial entities in the aggregate. The risks may be heterogeneous in the following ways: (1) the hedged risk will differ for each company; (2) the direction of the hedge may differ; (3) the timing of the hedge will differ; (4) the currency of the hedge may differ; and (5) the duration of the hedge will differ.

We urge Prudential Regulators to consider such facts by altering their proposal such that the new CVA capital requirements not apply to transactions executed with end-users when those end-users are hedging commercial risk. Not only would such an approach promote end-users' ability to reduce risk in a cost efficient manner, but it would promote consistency between the Proposal and Title VII of the Dodd-Frank Act.[11] Indeed, if Prudential Regulators did not make special provision for end-users in its Proposal, it would leave a striking inconsistency between the capital requirements framework and Title VII's end-user exception.[12] Congress has repeatedly emphasized this point throughout the regulatory process.[13]

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[10] Source: Bank for International Settlements, OTC derivatives market activity in the first half of 2011, November 2011. www.bis.org/publ/otc_hy1111.pdf

[11] Treasury Secretary Geithner noted that end-user hedging transactions were not suitable for central clearing, implicitly acknowledging that regulatory incentives to promote clearing should not be directed to end-user hedging transactions. In his comments to the International Monetary Conference in Atlanta, Georgia and June 6, 2011, he said, "…the law makes provisions for economically essential contracts that are not suitable for central clearing – for example, trades by non-financial end-users…"

[12] In a June 30, 2010 letter to House sponsors Congressmen Barney Frank and Colin Peterson, Senators Christopher Dodd and Blanche Lincoln wrote, "If regulators raise the costs of end-user transactions, they may create more risk. It is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end-users or impair economic growth." They further emphasized, "...a consistent Congressional directive throughout all drafts of this legislation, and in Congressional debate, has been to protect end-users from burdensome costs…"

[13] Senator Johnson, Senator Stabenow, Representative Bachus and Representative Lucas in their April 6, 2011 letter to Chairmen Gensler, Schapiro, Bernanke and Secretary Geithner wrote, "While we have been encouraged by many of your comments regarding capital and margin requirements, we write to reiterate the critical importance of establishing a regulatory regime that will not create economic disincentives for end-users to access the derivatives markets." House Committee on Agriculture Chairman Lucas and Senate Committee on Agriculture, Nutrition and Forestry Chairman Stabenow in a June 20, 2011 letter to Chairmen Blair, Bernanke, Gensler, Schapiro and Strom, Acting Director Demarco and Acting Comptroller Walsh, wrote, "In crafting Title VIII of Dodd-Frank, Congress was explicit in providing exemptions from mandatory clearing, exchange trading and margin for end-users hedging commercial risks. We are concerned that recent rule proposals may undermine

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Additionally, such an approach is consistent with actions European policy makers are presently considering with respect to Europe's capital requirements framework. European Parliament's CRD IV text includes a provision exempting corporate end users from the "own funds" requirement of the CVA requirement.[14] While CRD IV has not yet been finalized, we urge the Prudential Regulators to review Parliament's language exempting corporate end-users from this requirement. Moreover, we believe it critical for regulators in the U.S. and Europe to consistently treat end-users in both jurisdictions, and urge regulators to adopt an approach consistent with that currently being considered in Europe.

Summary

The OTC derivatives market today remains a critical risk management venue for end-user risk mitigation activities. Congress recognized the importance of preserving this market for end-users by crafting an end-user exception. Absent an exemption from the Proposal's CVA requirement, Title VII's end-user exception would be significantly undermined. This is because the Proposal would significantly increase derivatives transaction pricing, deterring end-users from hedging their risk, or causing them to hedge in an inefficient manner. Such effects would be particularly burdensome for small and medium sized businesses, as well as those that invest in long-term assets. We further urge Prudential Regulators to review the exemption for corporate end-users that is currently being considered by European policy makers, and to adopt a similar exemption.

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these exemptions, substantially increasing the cost of hedging for end-users, and needlessly tying up capital that would otherwise be used to create jobs and grow the economy." They further urged regulators to, "…to ensure that any new capital requirements are carefully linked to the risk associated with the uncleared transactions and not used as a means to deter over-the-counter derivatives trading." Senate Committee on Agriculture, Nutrition and Forestry Chairman Stabenow and Ranking Member Roberts in a February 22, 2011 letter to Chairman Gensler, wrote, "We appreciate your sensitivity to the concerns of commercial and agricultural end- users, who use derivatives to manage risks associated with their operations. As these people and businesses really had nothing to do with the financial crisis, we urge you to continue conversations with these market participants and to take their concerns into consideration as you write final rules so that their costs of risk management allow them to remain competitive."

[14] In its CRD IV text, European Parliament included an amendment (in italics) to Article 372 of the CRR which reads: "Transactions with a central counterparty *and transactions with non-financial counterparties referred to in Art. XX of EMIR, provided that these transactions are objectively measurable as reducing risks directly related to the commercial or treasury financing activities of the non-financial counterparty,* are excluded from the own funds requirements for CVA risk."

We thank you for the opportunity to comment on these important issues and are available to further discuss and answer any questions you may have.

Sincerely,
Agricultural Retailers Association
Business Roundtable
Financial Executives International
National Association of Corporate Treasurers
National Association of Manufacturers
U.S. Chamber of Commerce